IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

Nos. 286, 328.

GUY T. HELVERING, Commissioner of Internal Revenue, *Petitioner*,

v.

SOUTHWEST CONSOLIDATED CORPORATION, *Respondent*.

SAME

v.

ALABAMA ASPHALTIC LIMESTONE COMPANY.

BRIEF AMICUS CURIAE.

WALTER J. BROBYN,
EDGAR J. GOODRICH,
NEIL BURKINSHAW,
Washington, D. C.,
Amici Curiae.

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Introductory Remarks.

Authorization to file this brief Amicus Curiae obtained from counsel for the two respondent taxpayers designated and the Solicitor General of the United States is herewith submitted with this brief and it is respectfully prayed that this Honorable Court consider this brief Amicus Curiae in connection with its deliberations in the four cases consolidated for hearing as well as in connection with its subse-

quent decisions in cases now pending action of this Court on petitions for writs of certiorari in Cement Investors, Inc., No. 644, James Q. Newton Trust and James Q. Newton, Jr., Nos. 645, 646 and New Haven & Shore Line Railway Company, No. 780.

This brief is presented as friend of the Court to support the contention of the respective taxpayers that the decisions of the 9th Circuit Court of Appeals in the cases of Marlborough House, Inc. and Palm Springs Holding Company be reversed and that the decisions of the several Circuits in the remaining cases be affirmed.

It is not the purpose here to discuss any of the facts or attempt to point out any distinctions in the facts of any of the several cases consolidated for hearing, for it is believed that despite a number of differences the fundamental question is common to all.

Reduced to its fundamentals the question is simply this:

Does a non-taxable reorganization result within the meaning of the reorganization definition contained in Section 112 of the applicable revenue acts[1] where creditors of an insolvent corporation whose claims exceed the value of the corporate assets, adopt a plan of reorganization for the sole purpose of perpetuating the business enterprise of the corporation and also their exclusive interest in the assets under a new corporate form, and in pursuance of such plan appropriate legal proceedings are instituted by a creditors' committee or other representatives of their interests by which their exclusive interests in the assets are judicially established, after which such assets are transferred to a new corporation organized for the sole purpose of acquiring such assets and of continuing the business enterprise, and upon completion of the several related steps the object of the pre-existing plan of reorganization is achieved, namely, the creditors of the old corporation who have the sole beneficial interest in the assets become the stockholders of the new corporation with that same interest preserved?

[1] See appendices to briefs of parties herein.

Background of Controversy.

The history of this type of situation and the controversies arising between taxpayers and the Bureau of Internal Revenue is illuminating. In all instances the Bureau has taken the position which will gain the most tax, on the one hand contending for a statutory reorganization when individual bondholders or other creditors seek loss deductions by reason of their holdings in the old corporation, but on the other hand where it is to the taxpayer's advantage in establishing the basis for gain or loss or for depreciation or depletion allowance, the Bureau, ignoring its previous position, contends that each step in the procedure should be considered separately and that the requisites for a statutory reorganization are not present. This latter type of controversy is now before this Court for its decision.

At the time when the instant cases were pending before the Bureau of Internal Revenue or awaiting decision of the Board of Tax Appeals the Commissioner successfully sustained his contention that a statutory reorganization resulted, in the leading case of *Commissioner* v. *Irene O. Kitselman*, 89 Fed. (2d) 458, certiorari denied, 302 U. S. 709. The importance of the Kitselman decision was the adoption of the Commissioner's own theory by the 7th Circuit Court of Appeals (while at the same time the Commissioner was contending for an opposite theory before the Board of Tax Appeals where the basis question was involved) that where a corporation is so hopelessly insolvent that its stockholders have no interest in the assets, the creditors acquire the sole proprietary interest to such assets and are in substance pretty much the corporation. It was there held that this exclusive beneficial right in the creditors could be preserved under a new corporate set-up without altering the existing equities and further that participation of the old stockholders in the new set-up was unnecessary. In fact this theory advanced by the Commissioner and approved by the court in the Kitselman case had been the long standing view of the Commissioner as evidenced by the statement in his ruling as early as 1924 (I. T. 2071, III-2 C. B. 34) that—

> "When the reorganization is through a foreclosure sale, stockholders need not be joined in the plan nor given the right to participate, and if they are given the right to participate it is purely a matter of favor."

The Commissioner further emphasized this theory in his brief in opposition to the petition for certiorari to this Court in the *Kitselman* case where he stated on page 13 thereof—

> "The only reason the stockholders would not participate in the plan was that their stock represented no assets and was valueless, and therefore they were without right to speak. See In re 620 Church Street Corporation, 299 U. S. 24, 27. While the bondholders are ordinarily viewed merely as creditors, when the assets of the corporation in receivership are less than its obligations, the bondholders are for all *practical purposes* the corporation. All that remains for the stockholders is the corporate charter."

But now in the instant cases before this Court the Commissioner advances exactly the opposite proposition, that for all *practical purposes* the bondholders or other creditors remain nothing but creditors despite the insolvency of the corporation; that they never supplant the stockholders in the equitable ownership of the insolvent's assets. This contention, we submit, ignores realities and the long and well established doctrine with respect to corporate creditors in insolvency proceedings. (See *infra*, pp. 5, 6, 7.)

ARGUMENT.

Point I.

Bondholders of An Insolvent Corporation Have a Proprietary Stake in Its Property.

This brief is directed particularly against the Commissioner's contention that this Court's decision in *Letulle* v. *Scofield*, 308 U. S. 415, in effect nullified the doctrine of the Kitselman case, (Commissioner's Principal Brief in Southwest Consolidated Corporation, No. 286) with respect to a

creditor interest on insolvency taking the place of the stockholder interest.

A close analysis of the Letulle opinion in the light of the circumstances with which it dealt, does not impel such a conclusion; that case does not hold that the required "continuity of proprietary interest" may not have its source in the beneficial interest of creditors in the assets of an insolvent corporation. The opinion was confined strictly to the facts before it and applied to those specific facts the self-evident rule that bondholders of a financially solvent corporation have no "proprietary stake" in the enterprise; they are and remain during solvency merely creditors of the corporation.

Furthermore it is to be noted that this Court was speaking of a *present* situation, when it stated that merely because a bondholder would take the assets upon default, does not change "his status from that of a creditor to one having a proprietary stake within the purview of the statute". At the time of which the Court spoke the transferee corporation was solvent and the receipt of bonds by the transferor of property conferred upon him nothing more than a creditor status. Beyond question the present creditor status in connection with the solvent transferee could not be considered a proprietary interest merely because of the possibility of default in those bonds sometime in the future, and that is the length and breadth of this Court's decision in the Letulle case. It was speaking of a present solvent situation which could not be affected by a future eventuality.

In holding that bondholders of a present solvent corporation have no proprietary interest or stake in its assets, this Court did not even intimate that bondholders of an insolvent corporation have no proprietary interest. Indeed there are very strong pronouncements of this Court establishing the well recognized rule of equity that bondholders and other creditors have the sole beneficial interest where the assets are insufficient to satisfy their claims. Thus in *Hollins* v. *Brierfield Coal Co.*, 150 U. S. 371, 383, this Court said:

> "Solvent it holds its property as an individual holds his, free from the touch of a creditor who has acquired no lien * * *".

But in the same case the Court stated:

> "Becoming insolvent * * * places the property in a condition of trust, first for the creditors and then for the stockholders."

In *Northern Pacific Railroad Co.* v. *Boyd*, 228 U. S. 482 at p. 504, it was said:

> "The property was a trust fund charged primarily with the payment of corporate liabilities".

And in *Investment Register Ltd.* v. *Chicago M. E. Ry. Co.*, 212 Fed. 594 (C. C. A. 7th) at p. 609, where the corporation was hopelessly insolvent and its assets were insufficient to pay off the bonds in full, it was stated:

> "The property virtually belongs in equity to the bondholders".

See also *Graham* v. *La Crosse Ry.*, 102 U. S. 148, 161; *Mellen* v. *Moline Iron Works*, 131 U. S. 352; *Blake* v. *McClung*, 172 U. S. 239, 254, all recognizing the trust fund theory and the bondholders' beneficial interest to the exclusion of stockholders where insolvency occurs.

In tax cases too, this theory prevails substantially effecting tax consequences. Thus in *Commissioner* v. *Keller*, 59 Fed. (2d) 50[illegible], a radical difference appears dependent upon solvency and insolvency. The trust fund theory is strongly demonstrated also in transferee tax cases. *Price* v. *United States*, 269 U. S. 492, 502; *Phillips* v. *Commissioner*, 42 Fed. (2d) 177, 180.

So too, contrary to Commissioner's contention, in the instant cases this well recognized theory may not be ignored for tax purposes.

The term "proprietary" was not used by this Court in the Letulle case in any restricted or technical sense. Gener-

ally the term connotes ownership, dominion or control. It does not necessarily mean legal title for only the corporation has that until the judicial sale. This Court was referring to the beneficial or equitable interest when it used the term because even stockholders of a solvent corporation have only the beneficial interest in its assets with the right of pro rata distribution thereof upon dissolution, subject to prior claims of creditors. But when a corporation becomes hopelessly insolvent, as was the situation in the instant cases, and the value of the assets are such that only the creditors will participate therein, then at such time even before any formalities of liquidation or foreclosure, it is clear that the creditors have the complete proprietary interest to the exclusion of the stockholders. The stock represents no assets and is valueless. The management of the affairs of the insolvent corporation is thereafter carried on by or on behalf of the creditors. The stockholders as such are without the right to speak. *In re 620 Church Street Corporation*, 299 U. S. 24, 27; *Case* v. *Los Angeles Lumber Company*, 308 U. S. 106; *Consolidated Rock Products Co.* v. *Du Bois*, 312 U. S. 510.

Contrary to the Commissioner's contention in this regard in his principal brief in the Southwest Consolidated Corporation case (p. 26) it cannot reasonably be said that until some critical event, such as a foreclosure sale or consummation of a plan under Section 77B of the Bankruptcy Act, the stockholders in an insolvent corporation have the true "proprietary interest" in the sense intended by this Court in the Letulle case. The stockholders in certain rare instances may exercise the empty right of electing officers, but the real management lies in the receiver, committee or other fiduciary acting on behalf of the real beneficial proprietors, the creditors. It is doubtful whether any authority may be found to support the Commissioner's statement that stockholders still have the management, and control for themselves when the facts indisputably establish complete insolvency, and the worthlessness of their stock, before

the "critical event" mentioned by the Commissioner. Moreover, "management" is not always equivalent to "proprietary interest", and the Commissioner does not define his conception of the former term. If stockholders of an insolvent corporation whose shares are worthless by reason of the creditors' claims being in excess of the value of the assets, exercise any rights whatever it is solely by grace of the creditors. In such an event the exercise of such rights must be consistent with and not infringe upon the superior beneficial interests of the creditors. They must act, if at all, at the will of and for the benefit of the creditors.

Actually, the creditors' interests in the instant cases were more than "the anticipation of proprietary interest". The facts in each case show that the creditors, not the stockholders, had the sole right to speak and act with respect to the insolvent's assets. They had the beneficial ownership of the assets before any foreclosure, bankruptcy or receiver's sale, with the right to manage and control the assets and affairs of the corporation either through a receiver or committee acting for them. Possessing these essential elements of proprietorship they formulated plans of reorganization whereby the ultimate goal sought was the continuation of that beneficial or proprietary interest into a new corporate entity formed to receive the legal title and to carry on the business. Their beneficial interest was preserved by controlling stock ownership in the new solvent transferee. Thus the "continuity of proprietary interest" required by this Court from the old to the new corporation meets every essential test.

Point II.

Contention of Taxpayers Here is Consistent with the Intent and Purpose of the Reorganization and Basis Provisions.

The Commissioner has contended throughout the litigation in this series of cases and also contends before this Court that the result of the decisions below in favor of the

taxpayers is to give to the taxpayers tax benefits beyond the intent of the reorganization and basis provisions, because the effect of those decisions is to permit the taxpayers to use for depreciation and other basis purposes, the undepreciated bases of their predecessor corporations.

He apparently sees inequity in the result, because, according to his view, there was an absence of continuity of proprietary interest between the two corporations. Under such a state of affairs, says he, there is no permission in the statute—express or implied—nor is there any equitable or business justification for permitting a new corporation to continue to use the old corporation's basis. He concedes, however, that if there is a continuity of proprietary interest the result would be consistent with the tax laws.

Agreeing that the Commissioner's position might have some merit where no continuity of interest is preserved, nevertheless, we differ with him as to the result and effect of the decisions below in favor of the taxpayers. Instead of giving the taxpayers benefits beyond the intent and purpose of the statutory provisions, they were entirely consistent therewith, giving only what the law intended the taxpayers to have.

It has been generally held that the underlying purpose of the reorganization provisions of the revenue acts is merely to maintain the status quo in tax matters where a transfer is primarily a matter of form and not of substance. *Howard Hotel Corporation*, 39 B. T. A. 1147; *Rex Manufacturing Co. v. Commissioner*, 102 Fed. (2d) 325. That is exactly the result accomplished in the instant cases decided in favor of the taxpayers—the status quo before and after the reorganization was maintained.

Under the rule of the Kitselman and Newberry cases, which we submit are legally sound from a tax standpoint, the entire beneficial interest in the assets of the insolvent predecessor lodged solely in its bondholders or other creditors, was merely preserved under a new corporate form. They became stockholders of a new corporate entity whose enterprise was identical with or an enlargement and con-

tinuation of the predecessor's business operating along the same lines of endeavor and with the same equipment and personnel.

In every material respect the position of the former bondholders or creditors of the predecessors remained unchanged. Their stock holdings in the taxpayers represented in substance the same beneficial interest in the assets as held by them previously in the insolvent predecessors. It is true that under each new corporate set-up with the possible introduction of new capital their positions were at least potentially enhanced, but that was a prospect for the future. At the time of the consummation of the transfer, those former creditors did not in fact gain or lose by their change of status. Their stock in the aggregate acquired the same value as that of the assets transferred and consequently they remained at status quo.

Clearly, no gain or loss resulted to the former bondholders at the time of the transfer; those factors may be considered only at some future period upon the sale or other disposition of the stock they received.[2] This, we submit is the result intended to be achieved by Section 112(b)(3) of the Revenue Act providing for the recognition of no gain or loss where stock or securities in a corporation a party to a reorganization, are exchanged solely for stock or securities in another corporation a party to the reorganization. And where the beneficial interest is represented by bonds or long term obligations of an insolvent corporation, those obligations are "securities" within the meaning of that section. Indeed there is nothing in the Letulle opinion contrary to this rule, since this Court recognized its former holdings that bonds or long term obligations were "securities" within the meaning of the Act. It merely qualified

[2] It should be noted that the holders of millions of dollars in bonds of numerous insolvent corporations have been denied losses by the Commissioner in foreclosure reorganizations such as this on authority of the Kitselman case. Great inequity would now result after the statute of limitations has barred their right to claim such losses, if the Commissioner should be permitted to shift his former position sustained by the 7th Circuit Court and the Board.

such holdings where no proprietary interest is represented by the obligations, i.e., obligations of a solvent transferee.

Further analyzing the situation, it is also clear that the old corporation actually suffered no gain or loss by the transaction. After all the steps in the reorganization were completed its entity, in effect, became merged with that of the taxpayer and its enterprise continued under a mere change of form. The Revenue Act recognizes no gain or loss in such a situation. Here the old corporation was a party to a reorganization under Section 112(g)(2). As such a party to a reorganization, its assets were exchanged in pursuance of a plan of reorganization, solely for stock of another corporation a party to the reorganization. Section 112(b)(4). That provision does not state that the stock of the transferee must go to the transferor corporation itself. The provisions are satisfied if the stock goes to the former beneficial owners of its assets.

Only the stockholders of the old company suffered a loss, by reason of the worthlessness of their stock. But that fact does not negative a statutory reorganization, and is entirely beside the point. The creditors who had the real proprietary interest in the enterprise participated in the plan of reorganization and that interest endured in the final result accomplished. The stockholders did not participate in the reorganization for the simple reason that they had no interest with which to participate.

It is therefore perfectly apparent that no unreasonable tax benefits are conferred upon this taxpayer, nor does any inequity result by assigning to it, as successor in business, the basis for depreciation of its predecessor.

As a practical matter it should be noted that in all of these cases the unused basis of the predecessor for depreciation purposes was less than the original aggregate investment of the participating bondholders or other creditors who became the stockholders in the taxpayer corporation. Consequently the successor corporation through its stockholders gained no unfair advantage by the use of its predecessor's base and the Commissioner's alleged fears of unwarranted results are groundless.

Unique Application of Section 113 (a) (7).

A significant feature in Section 113 (a)(7) of the applicable Revenue Acts should be noted in connection with Commissioner's argument in that part of his principal brief devoted to "Practical Aspects of the Problem." (see pp. 13, 14, Petitioner's brief Southwest Consolidated case). In urging his point that a new cost basis should be adopted for the corporate taxpayer he states, "as a corollary, gain or loss will be recognized upon the exchange of the claims for stock of the new company since Section 112 (b)(3) will be inapplicable." Thus the Commissioner urges that since these reorganizations will not be tax-free reorganizations to the old creditors, the basis provision of Section 113 (a)(7) will not apply. Conveniently now for his present purpose Commissioner argues that his position in the *Kitselman* case was wrong.

But the Commissioner's reasoning does not necessarily follow merely because these reorganizations may be taxable to the security holders, if they are still within the terms of reorganization definitions in Section 112 (g).

Section 113 (a)(7) requires that property must be acquired by a corporation "in connection with a reorganization," etc. It is especially to be noted that it need not be a "tax-free" reorganization. Therefore, even though a transaction may not be tax-free with respect to the participants, the acquiring corporation may still be entitled to the basis of is predecessor under Section 113 (a)(7) provided the conditions as to control are met and the transaction is embraced within one or more of the definitions in Section 112 (g)(1). See in this connection *National Bank of Commerce of Seattle*, 40 B. T. A. 72, 77 aff'd. (C. C. A. 9th), 115 Fed. (2d) 875; *Muskegon Motor Specialties Co.*, decided November 4, 1941, 45 B. T. A. No. 91; and comment in 1942 C. C. H. Tax Service para. 778.01, where it is stated that transfers made in connection with reorganizations (even though not tax-free reorganizations) come within the meaning of Section 113 (a)(7).

Clearly, therefore, the Commissioner's comments as to recognizable gains or losses to the security holders are beside the point even if he may be right. Regardless of the tax effect on the participants or nonparticipants in the reorganization, the present corporate taxpayers are entitled to the bases of their predecessors under Section 113 (a)(7) if the other conditions of that Section are met, and each transaction comes within one or more of the definitions in Section 112 (g)(1).

It is not the province of this Brief Amicus Curiae to go into the varying elements regarding the compliance of each of these cases to the requirements of Sections 113 (a)(7), 112 (g)(1) of the 1934 and comparable provisions in other applicable Acts. Suffice it is to say that adequate and convincing discussion of these features appear in the several briefs of taxpayers filed herein, and we submit that those requirements were met, thus entitling the taxpayers to the bases of their defunct corporate predecessors.

Incidentally, it may be noted that the Commissioner in some of the instant cases attempted to destroy literal compliance with Clause B of Section 112(g)(1) of the 1934 Act (see Petitioner's principal brief in Southwest Consolidated Case, p. 21) by stating that the assets were not acquired solely for voting stock when such was actually the case. His claim is that "by hypothesis cash for dissenters * * * were also exchanged". But an examination of the records of each of the instant cases on consolidated hearing as well as of those pending this Court's action on petitions for writs of certiorari, disclose that either the dissenters were paid off by the cash raised by the "bondholders Committees",[3] or the payments of dissenters were obtained by loans which the acquiring corporations assumed. Under the retroactive 1939 amendment to Section 112(g)(1) the assumption of such an obligation was to be disregarded in

[3] This was the situation in *Helvering* v. *New Haven and Shore Line Railway Co.*, No. 780, now pending this Court's action. That case literally complied with Section 112(g)(1)(B) and Section 113(a)(7). See opinion of C. C. A. 2nd below, 121 Fed. (2d) 985.

determining whether the exchange was "solely" for voting stock (see comments in this regard Respondent's Brief, p. 15, Southwest Consolidated Case). Clearly the new requirement of Section 112(g)(1)(B) of the 1934 Act was satisfied in the cases governed by that Act now before this Court.

CLOSING STATEMENT.

The argument of the Commissioner in the instant cases, in effect, is that the taxpayers' bases for depreciation are to be governed completely by technical formalities incident to ordinary mortgage foreclosure proceedings or the like instituted by secured creditors of defunct corporations in *liquidation* of their affairs. In the opinion of amicus curiae, this contention is untenable in that it ignores the plain facts that the impelling motives in these cases were the desires to perpetuate rather than liquidate the businesses and that bondholders or other creditors' protective committees pursuant to preconceived plans of reorganization took all of the necessary steps towards that end, namely, the reorganization of an unsound corporate structure for the purpose of continuing a business enterprise.

Except for a few dissenters it was not a situation where a group of individual creditors desired to salvage what they could get from a bad investment, leaving the residue, if any, to the stockholders. In such a case it well may be argued that their aims could have been fulfilled by a pro rata distribution of the proceeds of the foreclosure or other sale. Instead, we have a situation where the creditors have banded together under the leadership of a formal committee interested only in continuing the business under a new corporate set-up and by a pre-conceived pattern of effort have taken all essential steps to that end.

Throughout the Commissioner's briefs in the instant cases is plainly the central theme that a proprietary inter-

est in corporate property means only shareholder interest. Plainly the proprietary interest in corporate property may take other forms than shareholder interest, especially when the corporation is insolvent and its stock worthless. Under such circumstances, stockholders have lost their proprietary interest to the creditors before any foreclosure or other judicial sale of the assets. The beneficial interest immediately vests in the creditors and a subsequent foreclosure sale merely transfers the bare legal title to the assets vested in the defunct corporation.

Clearly this situation reduced to these fundamentals satisfies the statutory definition of reorganization in Section 112 (g)(1) and the basis provisions of Section 113 (a)(7). The latter provision is concerned with "interest or control" remaining in the same persons or any of them immediately after the transfer. The term "interest" is a much broader term than ownership and would embrace any persons who have the ultimate beneficial rights in the property both before and after the transfer. Unquestionably, the bondholders or other creditors as beneficiaries of the trust fund had those ultimate beneficial rights in the property of each insolvent corporation and retained those rights by stock ownership in the required percentages immediately after the transfer. If Congress had meant to limit the word "interest" to "stockholder" interest, it would have used that word.

CONCLUSION.

Consideration of all of these factors demonstrates the errors in the argument of the Commissioner as well as in the opinions of the Ninth Circuit Court of Appeals in the Marlborough House and Palm Springs Holding Corporation cases, and discloses such a different situation from that prevailing in the Letulle case that, fully recognizing the "continuity of proprietary interest" rule therein enunciated, it

is still clear that the language therein employed does not have any governing application in the instant cases.

All of which is respectfully submitted.

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